MEMORANDUM OF FINDINGS OF FACT AND OPINION OF TAX COURT

NOTE: This case was heard by Judge Stephen E. Rice and briefs were thereafter duly filed. Upon the death of Judge Rice on February 9, 1958, this case was reassigned to Judge John E. Mulroney and notice was given to the parties that motions connected with the proceedings could be addressed to Judge Mulroney for a period of 30 days before final disposition of the case. No such requests have been received.

MULRONEY, *Judge:* The respondent determined deficiencies in income tax of petitioners for the years 1952 and 1953 in the amounts of $4,634.84 and $7,503.94, respectively.

The only issue before us is whether or not certain expenditures made in 1952 and 1953 are deductible by the petitioners in those years under section 23(a)(1)(A) of the Internal Revenue Code of 1939. Some concessions have been made by both parties which will be taken into account under a Rule 50 computation.

Findings of Fact

Lloyd U. Noland, Jr. and Jane K. Noland are husband and wife and reside in Warwick, Virginia. They filed joint Federal income tax returns for the taxable years 1952 and 1953 with the district director of internal revenue for the district of Virginia.

Lloyd U. Noland, Jr., hereinafter referred to as the petitioner, was, during the taxable years before us, the president and a director of the Noland Company, Inc., chairman of the board of directors of Virginia Engineering Company, Inc., a director of Tidewater Construction Corporation, chairman of the board of directors of Richmond Hotels,

president of the Biggs Antique Company, and president and director of the Antietam Hotel Corporation. The Noland family owns a controlling interest in the stock of the Noland Company, Inc., hereinafter referred to as the Company.

The Company has had for some time a policy of paying bonuses to its employees based on company profits. The amount of bonus to be paid to each employee, including so-called key personnel, was determined by a committee set up by the directors. During 1952 the petitioner received from the Company a salary of $12,230 and a bonus of $30,000. During 1953 he received from the same source a salary of $25,480 and a bonus of $15,000. Petitioner's salary is fixed by the board of directors.

During 1952 and 1953 the petitioner claimed as deductions certain expenditures which were labeled as follows:

1952

A. Dues and Subscriptions		
Propeller Club	$ 15.00	
The Hampton Roads Tidewater Field Trial Club	3.00	
Deep Run Hunt Association	10.00	
James River Hunt, Inc.	15.00	
Virginia Association Chiefs of Police	25.00	
Baltimore Country Club	23.10	
		$ 91.10
B. Non-reimbursable Business Expenses		
Evelyn H. Coleman, Florist	$ 36.25	
Diner's Club,	5.00	
Hotel Richmond	54.37	
Henri Fayette	13.50	
S. D. Huxley	2.00	

Hotel Chamberlin	3,795.55	
Hotel Chamberlin	169.11	
Camalier & Buckley	16.50	
James River Country Club	11.70	
Flax—Employees' Christmas party	150.00	
Biggs Antique Co., Inc.	413.46	
Horseman Florist	25.63	
Office Petty Cash	65.00	
The Hammond Company	97.50	
Young Men's Shop	67.35	
F. W. Woolworth (Favors for Employees' Party)	19.95	
		$1,942.87
Total expenses for 1952 remaining, in issue		$5,033.97

1953

A. Dues and Subscriptions

Baltimore Country Club	$ 15.00	
The Diner's Club	5.00	
James River Country Club	57.49	
The Deep Run Hunt Association	10.00	
"Personal from Pearson"	50.00	
Virginia Gold Cup Committee	15.00	
The Propeller Club of Port of Newport News	7.50	
The Press, Inc.	2.40	
Virginia Association Chiefs of Police	25.00	
The James River Hunt, Inc.	15.00	
Peninsula Industrial Committee	1,500.00	
Time	7.87	
		$1,740.26

B. NON-REIMBURSABLE BUSINESS EXPENSES

Evelyn H. Coleman, Florist	$ 96.00	
The Hammond Company	111.00	
Hotel Chamberlin	3,658.50	
Hotel Chamberlin	675.24	
Biggs Antique Company, Inc.	238.41	
Horseman Florist	95.24	
Hotel John Marshall	19.25	
Office Petty Cash	10.00	
Total of varied detailed expenses incurred on behalf of the Companies with which I am associated in the solicitation of business, entertainment of customers and associates, and building goodwill—which expenses have not otherwise been reimbursed or claimed as deduction	1,383.08	
		$6,286.72
Total expenses for 1953 remaining in issue		$7,996.08

The Company had for many years prior to 1952 sponsored a Christmas party for the general personnel of the Company. During the years before us the petitioner took it upon himself to sponsor a more elaborate party at the Hotel Chamberlin for such personnel and their families.

The petitioner allocated a substantial portion of the dues and subscriptions and alleged nonreimbursable business expenses which he incurred during the years before us between himself personally and the several companies with which he was associated. Many of the expenditures which were alleged to have been incurred for business motives were incurred by him not only on behalf of the Company but also

on behalf of the several other corporations with which he was associated.

The petitioner has not shown that any of the expenditures involved herein qualify as individual ordinary and necessary business expenses.

Opinion

The sole issue for our determination is whether certain expenditures made and claimed as deductions by the petitioner in the years before us qualify as ordinary and necessary business expenses in those years. There is no question concerning the fact that the amounts were paid as this was orally stipulated. Only the deductibility is in issue. Section 23(a)(1)(A), Internal Revenue Code of 1939,[1] provides in part that there shall be allowed as a deduction "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *." Petitioner has the burden of establishing that the expenditures were ordinary and necessary, and, as provided in Regulations 111, section 29.23(a)-1, that they were "directly connected with or pertaining to the taxpayer's trade or business."

Petitioner originally appears to have claimed certain of the expenditures (set out fully in our findings of fact) under one theory and others under another. The petitioner indicates that those expenditures labeled "Expenses paid for business purposes non-reimbursed" are claimed under section 23(a)(1)(A). Another group of expenditures labeled "Dues and Subscriptions" are claimed under either section 23(o) or section 23(a)(2). Thus we see that the petitioner did not originally label, or contend, that all of the expenses in question were business expenses.

[1] All references hereinafter to section numbers are to the Internal Revenue Code of 1939.

The opening statement of petitioner's counsel indicates that the theories under which the deductions are claimed are "as business expenses or otherwise". In petitioner's brief all of the expenditures are claimed to qualify as business expenses. It is generally contended that all of the expenditures were made by petitioner as ordinary and necessary expenses of his trade or business of being a corporate executive. Some of the expenditures, it is contended, were made for the benefit of the Company, but were made pursuant to a policy of the Company requiring or expecting its key employees to bear certain entertainment expenses of their offices. It does not seem to be argued that all of the expenditures came within this policy. The argument with respect to some of the expenditures was that they were ordinary and necessary business expenses because they were his own expenses in connection with his business of being a corporate executive.

The respondent contends that none of the expenditures qualify as petitioner's deductions, but that if any of such expenditures were ordinary and necessary business expenses, they were such expenses of the corporations and not the petitioner. We agree with the respondent.

We must start with the proposition that a corporation and its officers or stockholders are different entities. Consequently, the business of the corporation cannot be considered to be the business of its stockholders or officers. *Burnet* v. *Clark*, 287 U. S. 410. It is also well settled that the statute does not permit the deduction by one taxpayer of the expenses of a separate and distinct taxpayer. *Deputy* v. *DuPont*, 308 U. S. 488.

Petitioner argues that certain of the expenditures in question were made pursuant to a policy of the Company requiring or expecting him to bear such expenses. The

argument is that because of such policy these expenditures are shown to proximately result from, or are necessary to, his own "trade or business", that is, of being an officer of the corporation for whose benefit the expenditures were made.

All of the petitioner's evidence with respect to such policy that key employees should bear part of customers' entertaining expense and the relation of such expense to the realization of the corporate officers' own income is wholly unsatisfactory. The evidence of the existence of the policy is no more than the bare statement of the petitioner and one director that such a "policy" existed. This was for the most part in answer to leading questions as to whether they were aware of such a policy. No attempt was made to show there was such a policy by any documentary evidence and the evidence was not expanded at all beyond the bare self-serving statement of the petitioner and the vague statement of the other director. It affirmatively appears that the employees were not expected to incur nonreimbursable expenses in order to receive their full salary and the Company did reimburse all of what the witnesses called "normal" entertainment expenses by its officers. So the so-called policy is confined to certain expenditures which the witnesses term "extracurricular." The only attempt to relate the nonreimbursable expenses with the income of the officers was what is called the bonus plan. But here the evidence wholly fails to show that the payment of such expenses resulted in any increase in bonus.

The evidence with respect to the determination of the amount of each bonus was extremely vague. It seems the Company took 25 per cent of the profits before taxes and that constituted a bonus fund. There was a committee that determined the portion of the fund that was to be paid to any employee as a bonus. All we can learn from this record is

that the committee made its determination solely on the basis of business produced by each individual. The argument of the petitioner is that there was the incentive to engage in the so-called extracurricular entertainment in order to secure more business and thereby a larger bonus and that the key employees did just that. In the first place, the line between reimbursable entertainment expenses to produce business and the nonreimbursable entertainment expenses to produce business is unclear. The bonus amount was keyed to the production of business. Whether the expenses here were of the extracurricular variety we do not know. Petitioner here, in most instances, merely allocated a certain portion of each expense item to himself and had the Company, or other corporations of which he was an officer, pay the balance. Part of the amount he allocates to himself he termed nonreimbursable. No evidence was presented that any of the other several corporations in which petitioner was interested had any such policy. Petitioner was an officer of several corporations and many of the listed expenditures were admitted to have been made for the benefit of corporations other than the Company. Petitioner testified that he would take a total expense item and allocate it in some fashion among the several corporations and himself. Some of the expenses would be allocated to each corporation, some would be allocated to himself personally and some would be allocated to himself in his capacity as an officer of the corporations, which amounts he considered nonreimbursable business expenses. In other words, many of the so-called nonreimbursable business expenses were expenses of corporations, from which, as far as we know, petitioner received no income and which had no policy of requiring anyone to assume expenses on their behalf.

Even if we assume that the Company had a policy that required or expected employees to bear entertainment ex-

penses, we hold petitioner failed to carry his burden of showing the expenditures in question came within that policy.

It is contended that the largest expenditures made in the years before us, which was a Company Christmas party and listed in our findings of facts as "Hotel Chamberlin", come within the established policy of the Company. This is obviously not the case for the only policy described did not embrace employee entertainment expense. The petitioner testified that for many years the policy of the Company was to have a Christmas party at its own expense for its employees. He further testified that after he became president in 1951, he, personally, decided that it would be better if he gave the parties. He testified that, "*I* felt that the Christmas party would sort of help to maybe humanize *me* with the people there in the general office. You might say maybe *I* was trying to sell *myself* to the people in the general office." [Emphasis added]. It is obvious from this and other testimony that the decision that the petitioner would personally pay for the Christmas parties for employees of the Company was his own and was not because of any policy of the Company. Petitioner's voluntary expenditures for the entertainment of the Company's employees may have accomplished the desired result but would not be an expenditure connected with any trade or business of the petitioner. See *Harry Kahn*, 26 T. C. 273.

According to petitioner's witnesses the alleged policy of the Company related only to entertainment expenses of a nonroutine nature, looking to securing new business for the Company. Yet in the list of expenditures furnished by petitioner and labeled "Expenses paid for business purposes nonreimbursed" and found in our findings of fact, we find items completely unrelated to or very remote from the entertaining of such people. Such things as office supplies, ho-

rel expenses for the wife of an employee, flowers for wives of directors of the corporations in which petitioner had an interest, and an item of $67.35 for uniforms "for the colored boy that works in our house, * * *". Many other items were just as remote to any policy of the Company, or to the realization of petitioner's income, and must be treated accordingly.

In general, the record as to the purposes for which all of the expenditures were made is very unsatisfactory. Typical of the vague testimony is petitioner's explanation of an expenditure in 1953, amounting to $1,383.08, which was headed, "Total of varied detailed expenses * * *". Petitioner testified, "Well, $833 of it are detailed items which were spent by me during the year in connection with my being President Noland, Chairman of the Board of Virginia Engineering, et cetera, and $500 of it is an estimate by me of similar expenses which I had incurred but for which I have not otherwise accounted." The $500 item was later described by petitioner as having been to a large extent for entertaining at home. This expenditure was one of the larger items expended in 1953 and the quoted testimony is typical of the petitioner's efforts to prove that such items were directly connected with or pertained to the trade or business of the Company or his own trade or business of being a corporate officer.

Certainly any sums paid on behalf of other corporations can not qualify as petitioner's expenses but must be deducted, if at all, by the individual corporations which incurred the expense. *See Jacob M. Kaplan*, 21 T. C. 134. Since we have no evidence by which we can determine the extent to which sums were expended solely for the benefit of the Company, even though we assume the Company had some sort of a nonreimbursement policy, we must sustain

the respondent's determination as to those deductions claimed as nonreimbursed business expenses.

The record is not clear as to expenditures which were allegedly made, not for the benefit of any corporation, but for the benefit of the petitioner in his own trade or business of being a corporate executive. Most of the items consist of dues to clubs and subscriptions to certain reading matter. The respondent allowed certain of the subscriptions to business periodicals as deductions but disallowed the balance as personal expenses not incurred in connection with the performance of petitioner's duties.

We do not think that petitioner has shown that such deductions, disallowed by the respondent, were necessary to his business. Petitioner testified that for the most part the clubs were joined upon solicitation and that he did not attend any of their meetings or use them in any way. The mere statement that he would not have joined such clubs but for his "business connection" is not sufficient proof that such club dues were ordinary and necessary to the realization of his own income. For the most part it is obvious that petitioner's reasons for joining such clubs or organizations were because petitioner was a generous, civic minded individual.

We are sure that such was the case of the largest single item under "Dues and Subscriptions" in 1953. We refer to the $1,500 deduction of a contribution to the Peninsula Industrial Committee, an organization formed to encourage new industry to the Newport News area. Petitioner was chairman of the fund raising committee of the organization. The Company, and at least one other corporation in which petitioner was interested, made separate contributions to the fund. The reasons given by petitioner for considering the contribution a business expense was that "anything that helps the community helps the business of which I am a

part, and I think anything that helps the business of which I am a part helps me."

We do not think that an expense so remote or far removed from the realization of petitioner's income or business is directly connected with or pertains to the taxpayer's trade or business. Or, another way of putting it, we do not think that the expense proximately or immediately relates to his own business. See *Jacob M. Kaplan, supra.* For this reason it must be disallowed.

It would serve no useful purpose for us to itemize each and every deduction claimed by petitioner and point out our reasons for sustaining the respondent on each of them. The examples which we have pointed out serve to demonstrate the petitioner's failure of proving that any of such expenses were ordinary and necessary business expenses of the petitioner.

Decisions will be entered under Rule 50.

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Before SOBELOFF, Chief Judge, and SOPER and HAYNSWORTH, Circuit Judges.

HAYNSWORTH, Circuit Judge:

By their petition to review a decision of the Tax Court, Lloyd C. Noland, Jr. and his wife, who filed joint returns, seek to overturn the Commissioner's disallowance of miscellaneous deductions claimed as business expenses of the husband.

The taxpayer, Mr. Noland, is an executive of six corporations conducting substantial and profitable businesses. He is the president and a director of the Noland Company, Incorporated, which has its principal office in Newport News, Virginia, and which is engaged, in several states, in the wholesale distribution of plumbing, heating, industrial and electrical equipment and supplies, and of machine tools. He is chairman of the board of directors of Virginia Engineering Company, Inc., a director of Tidewater Construction Corporation, chairman of the board of directors of Richmond Hotels, Incorporated, president and a director of Biggs Antique Company, Incorporated, and president and a director of Antietam Hotel Corporation.[1]

His adjusted gross income exceeded $299,000.00 in 1952

[1] The Noland Company was founded by the taxpayer's father and was well-established when the taxpayer became employed by it. He and members of his immediate family are its controlling stockholders. So far as appears, though it is uncertain on this record, each of the other companies were established before his association with them, and he, or members of his family, are the owners of substantial proportions of the stock of each. At least, no contention is made here that the taxpayer is a promoter, a management consultant or a specialist in the revitalization of declining managerial organizations, or that he is engaged in any business other than that of earning his compensation from the enumerated corporations.

and $263,000.00 in 1953, the years with which we are concerned. His compensation by the Noland Company in 1952 was $42,230.00, of which $12,230.00 was his salary and $30,000.00 a bonus, and in 1953, $40,480.00, of which $25,480.00 was salary and $15,000.00 a bonus.

The expenses with which we are concerned may be classified as follows:

(1) The largest single item in each year was the cost of an elaborate party given at Christmas time for the personnel of the home office of the Noland Company. For years, the company, itself, had been giving a Christmas party in its offices, but the taxpayer felt they were of little worth. After he became president in 1951, he decided to enlarge the party by including the spouses of employees, to move the party to the Hotel Chamberlin and to add entertainment and dancing. He also decided to pay for the party, out of his own funds, because, he testified, he felt that would improve his personal relations with the personnel of the home office and relieve the company from pressure to give similar parties for the personnel of each of its many branch offices.

(2) In 1953, the Peninsula Industrial Committee, an affiliate of the Virginia Peninsula Chamber of Commerce, undertook to raise $125,000.00 for use in promoting the industrial development of the area. The taxpayer was a member of the board of the Committee, and served as chairman of the campaign. Obviously, the businesses of some of the companies for which the taxpayer worked were closely related to the purposes of the Committee, and they contributed to the campaign. In addition, the taxpayer made a personal contribution of $1500.00 to the campaign, which met with prompt success. Most of the contributions to the campaign were by corporations, but there were over 200 individual contributors.

(3) Dues to a number of clubs and associations, some of which, he testified, he used not at all, but had joined because some business associate or customer had requested him to do so, one of which he used for the entertainment of business associates and others of which he had joined because it gave him an opportunity to mingle socially with people he regarded as actual or potential customers, or in position to "influence" business.

(4) Subscriptions to periodicals of general interest, such as *Time*. The cost of subscriptions to matter more exclusively of business interest, as the *Wall Street Journal*, was allowed by the Commissioner. The taxpayer testified it was necessary that he be informed of general affairs in order to converse effectively with his associates and make speeches.

(5) Contributions to schools, a public library and other organizations which the Commissioner agreed would qualify as charitable contributions, but not as business expense.

(6) A general miscellany of expense items, principally relating to entertainment, much of it in taxpayer's home, and to gifts and remembrances. Many of these items are a prorated portion of the total cost, other portions of the total cost having been charged to one or more of the corporations as reimbursable expense. The unreimbursed portion of these items was subject to a further allocation between "unreimbursed business expense," for which deduction was claimed, and "personal expense" for which no deduction was claimed. The allocations were his own, and he made no attempt to obtain complete reimbursement for these items, for he felt the total cost was not properly chargeable to the corporations.

We start with the assumption that every person who works for compensation is engaged in the business of

earning his pay, and that expense which is essential to the continuance of his employment is deductible under § 23(a)(1)(A) of the Internal Revenue Code of 1939 (26 USCA §23). See *Hill* v. *Commissioner*, 4 Cir., 181 F.2d 906; *Schmidlapp* v. *Commissioner*, 2 Cir., 96 F.2d 680. Salary has been treated as business income within the meaning of § 122 of the Internal Revenue Code of 1939. *Batzell* v. *Commissioner*, 4 Cir., F.2d (April 15, 1959); *Roberts* v. *Commissioner*, 5 Cir., 258 F.2d 634; *Pierce* v. *United States*, 9 Cir., 254 F.2d 885; *Overly* v. *Commissioner*, 3 Cir., 243 F.2d 576; *Folker* v. *Johnson*, 2 Cir., 230 F.2d 906. The business of a corporation, however, is not that of its officers, employees or stockholders. Though the individual stockholder-executive, in his own mind, may identify his interest and business with those of the corporation, they legally are distinct, and, ordinarily, if he voluntarily pays or guarantees the corporation's obligations, his expense may not be deducted on his personal return. *Deputy* v. *du Pont*, 308 U.S. 488, 60 S.Ct. 363, 84 L.Ed. 416; *Welch* v. *Helvering*, 290 U.S. 111, 54 S.Ct. 8, 78 L.Ed. 212; *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 63 S.Ct. 1279, 87 L.Ed. 1607; *Burnet* v. *Clark*, 287 U.S. 410, 53 S.Ct. 207, 77 L.Ed. 397. Nor may a corporation deduct as a business expense, payments which clearly further the businesses of its stockholders, but not its own: *City Ice Delivery Co.* v. *United States*, 4 Cir., 176 F.2d 347. The rule has particular applicability to closely held corporations where there may be temptation to transfer expense so that it may be deducted in the highest brackets. It is not suggested that the taxpayer here, when he personally assumed the cost of the annual Christmas party of the Noland Company, was prompted by any motive other than those he declared, but he was the dominant officer and stockholder, and the fact is that the deduction on his return, rather than upon the corporation's

would produce a net loss of revenue, a circumstance which naturally causes the Commissioner to look askance at the transaction.

The taxpayer, here, does not question the rule. Rather, he sought to prove in the Tax Court that the Noland Company required him to incur the expenses. His proof shows that the Noland Company, since its inception many years ago, has pursued a policy of paying liberal bonuses to those key employees whose efforts had been most productive. Under a continuing plan, twenty-five per cent of profit before taxes is set aside each year as a bonus fund. In the years in question and those immediately preceding, the fund approximated a million dollars a year. A committee of directors, including taxpayer, allocated the fund among the executives and key employees in the home and branch offices, and there was testimony that it had been so handled that the participating employees had a reasonable expectancy of appropriate reward in the bonus allocation for increases in business.

There was also testimony that the Noland Company restricted the use of expense accounts. Salesmen and executives were reimbursed for their "normal" expenses, including the cost of entertainment of customers having current business relations with the company, but were not reimbursed for expenses incurred in the "extra curricular" promotion of new business or the entertainment of fellow employees.

It is doubtful that this showing *differentiates* this company from hosts of others which employ liberal bonus and incentive plans and which impose reasonable limitations upon the use of expense accounts. A director testified that the two policies had led him to feel encouraged to spend his money as well as his time in extra hours in an effort to develop new business, and, doubtless the bonus plan did encourage additional effort. The testimony would sup-

port a finding that there was relation between increases in business and the amount of the bonus of the employees who produced it, but no suggestion that the amount of money an employee spent in promotional activity had any direct effect upon his bonus or was even known to the directors who allocated the bonus fund.

As proof of an affirmative requirement that the taxpayer make the expenditures in question, we agree with the Tax Court, that it was "vague" and "unsatisfactory." A different inference seems more likely. While an employee, generally, was not reimbursed for his cost in entertaining his fellow employees, the company had paid the cost of the Christmas party for years. There is no suggestion that it would not have done so in 1952 and 1953, if the taxpayer had not elected to stand the cost himself. There was no direct testimony relating the supposed policy to the taxpayer's contribution to the Peninsula Industrial Committee, to which the company also contributed, and the taxpayer's entertainment expense was allocated in part to the company. Perhaps the Commissioner or the Tax Court might have found that the taxpayer's allocation of his entertainment expense was a result of the supposed policy and in accordance with it, but the taxpayer's only testimony was that he attempted an "equitable" allocation of those expenses.

Certainly the proof was not so certain or definite as to compel a finding that these expenditures were required by the company[2] or the conclusion that they were deductible business expenses of the taxpayer.

A corporate executive is normally expected to be responsive to his social obligations and to discharge his civic and community responsibilities. These usually grow

[2] See *Hill* v. *Commissioner*, 4 Cir., 181 F.2d 906; *Schmidlapp* v. *Commissioner*, 2 Cir., 96 F.2d 680.

in magnitude as the executive grows in success, and, doubtless, it is true, as the taxpayer suggests, they have a certain relation to the positions he occupies, for the positions measure his personal success and affluence. They are, nonetheless, his obligations and responsibilities, and the expense their recognition imposes upon him is personal, not business expense. So his expenditures to increase his general learning, to keep informed and increase his personal effectiveness are personal. As Mr. Justice Cardozo said in *Welch* v. *Helvering*, 290 U.S. 111, 54 S.Ct. 8, 78 L.Ed. 212:

> "* * * Reputation and learning are akin to capital assets, like the good will of an old partnership. Cf. Colony Coal & Coke Corp. v. Commissioner of Internal Revenue (C. C. A. 4th) 52 F. (2d) 923. For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business."

They are comparable to expenses to qualify oneself for advancement or to obtain new office. *McDonald* v. *Commissioner*, 323 U.S. 57, 65 S.Ct. 90, 89 L.Ed. 68; *Mays* v. *Bowers*, 4 Cir., 201 F.2d 401. It is greatly to be doubted that expenses, which are clearly personal in nature, could be converted into business expenses of the individual by a formalistic requirement of his employer that they be incurred. Personal, living and family expenses are non-deductible by the express provision of § 24(a)(1). No magic form of words occurs to us by which an employer can convert them into something else, and relieve his employees of a portion of the tax burden uniformly borne by all other individuals.

To distinguish between such expenditures and those having a closer relation to business is not easy. Numerous turn

upon particular factual situations, and distinctions are usually a matter of degree. If the expense has been billed to an employer and has passed a critical scrutiny of corporate officers concerned with the elimination of needless expense, it becomes prima facie an allowable business expense of the corporation. When the corporation, reimbursing its officers and employees for direct expense incurred in furthering its business, does not reimburse an officer for particular expense, that expense prima facie is personal, either because it was voluntarily assumed or because it did not arise directly out of the exigencies of the business of the corporation. See *Commissioner* v. *Flowers*, 326 U.S. 465, 66 S.Ct. 250, 90 L.Ed. 203.

To establish that a particular expense, though unreimbursable, was an ordinary and necessary expense of the business of the executive, apart from that of the corporation, requires proof of some certainty and directness. We agree with the Tax Court that the proof here was deficient in those qualities.

The Tax Court found, and the evidence shows, that the taxpayer is a man of generosity and public spirit. His testimony also shows, not unnaturally, that he identifies himself and his business with the several corporations and their businesses, and all of these are further identified with the interest and growth of the community. Such identification frequently lends a business significance to personal hospitality and generosity without making either wholly factitious,[3] but the business significance, upon this showing, is immediately that of the corporations, only derivatively that of the executive-stockholder. See *Greenspon* v. *Commissioner*, 8 Cir., 229 F.2d 947.

Affirmed.

[3] See *Schmidlapp* v. *Commissioner*, supra.

SCHMIDLAPP v. COMMISSIONER OF INTERNAL REVENUE

No. 213

Circuit Court of Appeals, Second Circuit
May 2, 1938

Before L. HAND, SWAN, and AUGUSTUS N. HAND, Circuit Judges.

L. HAND, Circuit Judge.

This appeal is from an order of the Board of Tax Appeals, assessing added income taxes against the taxpayer for the years 1931 and 1932. The issues relate to deductions of which four are in dispute, and all of which the Board disallowed; to identify them we shall call them, (1) entertainment expenses; (2) apartment rent; (3) loss on Winchester-Simmons shares; (4) loss on Chase Bank shares. As they are quite separate and involve different considerations, we may take them up seriatim.

(1) Entertainment Expenses

[1] The taxpayer was a vice-president of the Chase National Bank of New York, which expected that as part of his duties he would entertain at his own expense visitors whose favor the bank desired; just as some manufacturers entertain the buyers of mercantile houses to induce their patronage. The taxpayer lived lavishly, and swore that a substantial part of his expenses were incurred to discharge this implied duty; he estimated that his outlay upon such guests amounted to $3,000 in each year. The case comes up only upon the Board's finding and its meaning is equivocal;

it was as follows. "The record of such expenditures is very unsatisfactory. With the exception of the item of 'Recess Club Charges' no expenditures were specifically attributable to entertaining bank customers, and none was adequately proved." We cannot tell why the proof was inadequate, and possibly should not have agreed that it was, but as the record stands we must take it that only the "Recess Club Charges" were sufficiently proved—$590.75 in 1932. If proved, these outlays were, however, deductible. In Cohan v. Commissioner, 2 Cir., 39 F.2d 540, we held that the expenses of an impresario in entertaining the actors and chorus during the period of rehearsals, was one of the "ordinary and necessary expenses * * * in carrying on" his business; and we cannot see anything to distinguish the expenses at bar, so far as they really were to drum up business for the bank, though it was proper to be extremely suspicious as to how far that was their purpose. It is no answer to say that they were for the bank's benefit; so were all the taxpayer's services; if it did in fact give him to understand that he was to extend a factitious hospitality in its interest, the cost of it was a necessary expense of his office. The Commissioner does not ask us not to recognize such an arrangement as lawful, and indeed any compunctions as to its propriety lie rather in the field of dignity and good taste, than of morals. To the extent of $590.75 in the year 1932, the deduction should have been allowed.

* * *

The order will be modified as to the first item by deducting $590.75 from the income for 1932; it will be affirmed as to the second item; it will be reversed and the claimed deductions allowed as to the third and fourth items.

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In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 373

LLOYD U. NOLAND, JR., and JANE K. NOLAND,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals is not as yet reported. (App. 13.)[1] The Tax Court's memorandum findings of fact and opinion (R. 78-90)[2] are not officially reported.

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[1] References to App. are to the appendix to the petition for certiorari.

[2] Record references are to the appendix to the taxpayers' brief in the Court of Appeals.

JURISDICTION

The judgment of the Court of Appeals was entered on June 10, 1959. The petition for certiorari was filed on September 4, 1959. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether the courts below properly held that certain expenditures made by a corporate executive were his personal expenses not deductible under Section 24(a) of the Internal Revenue Code of 1939 rather than business expenses deductible under Section 23 (a) (1) (A).

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while

away from home in the pursuit of a trade or business; * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) [as amended by Sec. 127(b), Revenue Act of 1942, *supra*] *General rule.*—In computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses, except extraordinary medical expenses deductible under section 23(x); * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 24.)

STATEMENT

This case concerns the disallowance by the Commissioner of Internal Revenue of various deductions for 1952 and 1953 claimed as business expenses by Lloyd U. Noland, Jr.,[3] and the affirmance of such disallowance by the Tax Court and by the Court of Appeals for the Fourth Circuit. The taxpayer is an executive of six corporations conducting substantial and profitable businesses. He is the president and a director of the Noland Company, Inc., which has its principal office in Newport News, Virginia, and which is engaged in the wholesale distribution of plumbing, heating, industrial and electrical equipment and supplies, and of machine tools. He also is chairman of the board of directors of Virginia En-

[3] Noland and his wife filed joint returns for the taxable years 1952 and 1953. Mr. Noland will be referred to hereafter as the taxpayer.

gineering Company, Inc., a director of Tidewater Construction Corporation, chairman of the board of directors of Richmond Hotels, Inc., and president and a director of Biggs Antique Company, Inc., and Antietam Hotel Corporation. (App. 13). The Noland Company, since its inception, has pursued a policy of paying liberal bonuses to those key employees whose efforts had been most productive. Under a continuing plan, twenty-five per cent of profit before taxes is set aside each year as a bonus fund. A committee of directors, including taxpayer, allocated the fund among the executives and key employees in the home and branch offices; and there was testimony that it had been so handled that the participating employees had a reasonable expectancy of appropriate reward in the bonus allocation for increases in business. (App. 17.)

Taxpayer's compensation by the Noland Company in 1952 was $12,230 in salary and $30,000 in bonus; in 1953 it was $25,480 in salary and $15,000 in bonus. In 1952, his total adjusted gross income exceeded $299,000 and in 1953 it exceeded $263,000. (App. 13-14.)

The disallowed expenditures fall into the following groups:

(1) The largest single item in each year was the cost of an elaborate party given at Christmas time for the personnel of the home office of the Noland Company. For years the company itself had been giving a Christmas party in its offices, but the taxpayer felt they were of little worth. After he became president in 1951, he decided to enlarge the party

by including the spouses of employees, moving it to the Hotel Chamberlin, and adding entertainment and dancing. He also decided to pay for the party out of his own funds because, he testified, he felt that it would improve his personal relations with the personnel of the home office and relieve the company from pressure to give similar parties for the personnel of each of its many branch offices. (App. 14.)

(2) In 1953, the Peninsula Industrial Committee, an affiliate of the Virginia Peninsula Chamber of Commerce, undertook to raise $125,000 for use in promoting the industrial development of the area. The taxpayer was a member of the board of the Committee, and served as chairman of the campaign. The businesses of some of the companies for which the taxpayer worked were closely related to the purposes of the Committee, and such companies contributed to the campaign. In addition, the taxpayer made a personal contribution of $1,500. (App. 14.)

(3) Dues to a number of clubs and associations. The taxpayer testified that he used some of these not at all but had joined because some business associate or customer had requested him to do so; that one was used for the entertainment of business associates; and that he had joined others because it gave him an opportunity to mingle socially with people he regarded as actual or potential customers, or in position to influence business. (App. 15.)

(4) Subscriptions to periodicals of general interest such as Time Magazine. The taxpayer testified it was necessary that he be informed of general affairs in order to converse effectively with his associates and make speeches. (App. 15.)

(5) A general miscellany of expense items, principally relating to entertainment, much of it in taxpayer's home, and to gifts and remembrances.[4] Many of these items are a prorated portion of the total cost, other portions having been charged to one or more of the corporations as reimbursable expense. The unreimbursed portion of these items was subject to a further allocation between "unreimbursed business expense," for which deduction was claimed, and "personal expense," for which no deduction was claimed. (App. 15.)

The taxpayer sought to prove in the Tax Court that the Noland Company required key employees to bear a part of customers' entertaining expense, and that there was a relation of such expense to the realization of the corporate officers' own income. However, the Tax Court found to the contrary, holding that it affirmatively appeared that the employees were not expected to incur nonreimbursable expenses in order to receive their full salary, and that the Noland Company did reimburse all of what the witnesses called "normal" entertainment expenses by its officers. Additionally, it held that the evidence wholly failed to show that the payment by officers of so-called "extracurricular" expenses resulted in any increases in bonus. (App. 7, 18.)

[4] Included in the group entitled "unreimbursed business expense" are items such as office supplies, hotel expenses for the wife of a hospitalized employee, flowers for wives of directors of the corporations in which taxpayer had an interest, and an item for uniforms "for the colored boy that works in our house". (App. 9-10, 15.)

The Tax Court held that the taxpayer failed to prove that any of the expenses in question were the ordinary and necessary expenses of his trade or business (App. 12), and the Court of Appeals for the Fourth Circuit unanimously affirmed.

ARGUMENT

This case presents no more than a factual question. It involves no questions of general importance, and contrary to the assertions of the taxpayer, the decision below does not conflict with those of any Court of Appeals. There is no occasion for further review.

At the outset, it must be noted that the taxpayer is claiming the deductions in question as expenses of his trade or business. This case does not involve in any respect the question of whether or not such expenses would have been deductible by his corporate employers had they paid such expenses. The expenses in controversy were paid by the taxpayer and the only question is whether or not they were incurred as a part of his trade or business.[5] It is clear, as the Fourth Circuit pointed out (App. 15-16), that the taxpayer, like every other person who works for compensation, is engaged in the business of earning his pay. It therefore follows that any expense which is essential to the continuance of such employment is deductible as an expense of his trade or business.

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[5] Taxpayer's "Question Presented" states that the business purpose of the expenditures is undisputed. (Pet. 1.) Far from being undisputed, whether or not the expenditures had a business purpose to taxpayer is at the crux of this case.

See *Hill* v. *Commissioner*, 181 F. 2d 906 (C.A. 4th); *Schmidlapp* v. *Commissioner*, 96 F. 2d 680 (C.A. 2d). However, the corporation and its officers and stockholders are different entities. The business of the corporation is not that of its officers, employees, or stockholders. *Burnet* v. *Clark*, 287 U.S. 410. Thus, even though any given expense might have been deductible by the corporation had it been paid by the corporation, the same result does not follow if it was in fact paid by the individual officer or employee. *Welch* v. *Helvering*, 290 U.S. 111; *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590; *Deputy* v. *du Pont*, 308 U.S. 488. Such items, when paid by officers or employees, are not necessarily expenses of their own trade or business of earning compensation. If not essential to such trade or business, they fit within the category of personal living or family expenses which are specifically made non-deductible under the terms of Section 24(a)(1) of the 1939 Code, *supra*. Correctly applying these principles to the facts here, both the Tax Court and the Court of Appeals held that the taxpayer did not incur the expenses in question as necessary expenditures to the continuance of his business of earning his pay.

Taxpayer sought to prove in the Tax Court that the Noland Company required him to incur the expenses. (App. 17.) Thus, the taxpayer argues that the officers of Noland have been expected to absorb various promotional expenses out of their own pockets without seeking reimbursement from the company, in contrast to routine disbursements like travel expenses, which are reimbursed. (Pet. 3.) But the Tax Court found

that taxpayer had failed to prove any such requirement or expectation on the part of the company (App. 7), and the Fourth Circuit agreed that any proof in this respect was vague and unsatisfactory. (App. 18.) The taxpayer simply failed to prove this point before the trial court. The situation in this case is very different from that presented in *Schmidlapp* v. *Commissioner, supra*, where the taxpayer was able to prove that he was required, as part of his duties as an employee of the Chase National Bank, to entertain bank customers at his own expense.

Even if it be assumed that the Noland Company required taxpayer and other officers to incur various promotional expenses without reimbursement, the bulk of the expenditures in question still would not be deductible. This so-called policy of the Noland Company (unproven by taxpayer) was to aid in the promotion of new business. Taxpayer has not shown how the Christmas party for employees during 1952 and 1953 fits within this standard. In fact, it is undisputed that the company had paid for the cost of the party for years and there is no suggestion that it would not have continued to do so during 1952 and 1953 had not the taxpayer taken it upon himself to stand such cost. (App. 18.) There is no showing whatsoever that the company required taxpayer to incur this expense; indeed, the evidence is to the contrary in that taxpayer admittedly undertook the expense in order to improve his personal relations with the employees. (App. 14.) However, it was not necessary that taxpayer make such an expenditure in order to con-

tinue earning his pay from the Noland Company. Accordingly, even though these expenditures might have furthered the business purposes of the company, they did not further the business purposes of the taxpayer—*viz.*, earning his compensation from the company.

Each of the other claimed deductions likewise fails to meet the requirement of being an ordinary and necessary expense of taxpayer's business of earning his compensation. Thus, subscribing to Time Magazine, purchasing uniforms for a house-servant, paying for the hotel expenses of the wife of an ill employee, do not, as the Tax Court stated, proximately or immediately relate to the taxpayer's own business." (App. 12.) The Fourth Circuit aptly summed up the situation in this case when it stated (App. 18-19):

> A corporate executive is normally expected to be responsive to his social obligations and to discharge his civic and community responsibilities. These usually grow in magnitude as the executive grows in success, and, doubtless, it is true, as the taxpayer suggests, they have a certain relation to the positions he occupies, for the positions measure his personal success and affluence. They are, nonetheless, his obligations and responsibilities, and the expense their recognition imposes upon him is personal, not business expense. So his expenditures to increase his general learning, to keep informed and increase his personal effectiveness are personal.

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[6] In addition, many of the expenses related to companies other than the Noland Company. As to these, taxpayer made no attempt at all to show that such companies required him, as an employee, to incur such obligations.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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Supreme Court of the United States

October Term, 1959

LLOYD U. NOLAND, JR., AND
JANE K. NOLAND,

Petitioners,

v.

COMMISSIONER OF INTERNAL
REVENUE,

Respondent.

REPLY TO BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI

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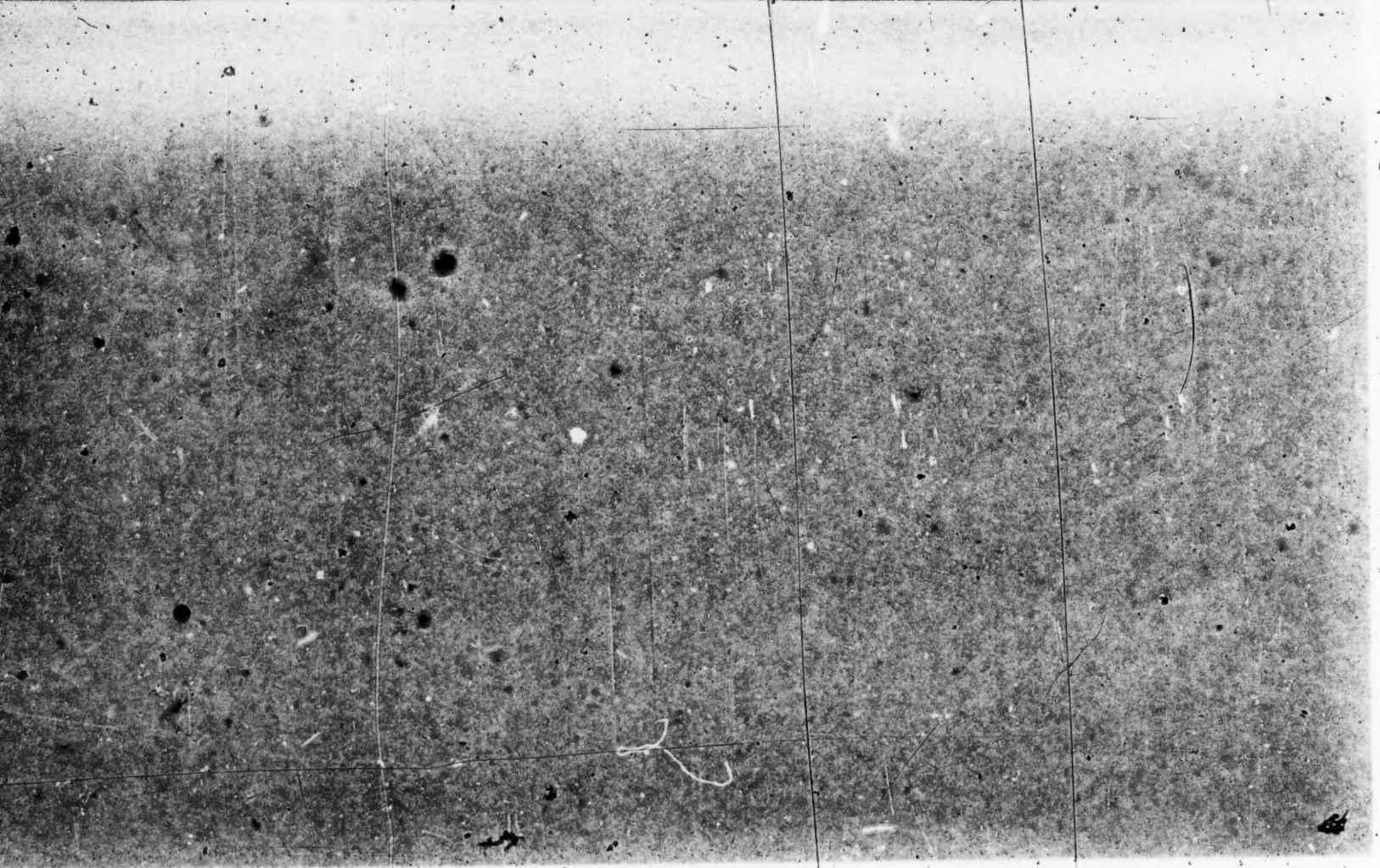

The Brief of the Respondent dismisses summarily the one important question in this case by labelling it "factual" and focuses on certain disallowed deductions which Petitioner already has pointed out do not in and of themselves merit this Court's review.[1] And other than asserting that there is no conflict between the opinion below and the *Schmidlapp* case[2] Respondent ignores the arguments made in Petitioner's Brief. But the Government's treatment of taxpayer's case only highlights the significant differences of opinion that exist, among the courts of appeals and within the Tax Court, on the important question presented by this case concerning deductions by employees of expenses incurred in earning their salaries.

The Government's assertion that the case "presents no more than a factual question" is based on the premise that an employee may deduct *only those expenses he incurs under compulsion*. Having made this assumption, the Government then asserts that taxpayer failed to prove that he was "required" by the company to give the Christmas Party for the employees of the company at his own expense. And if *compulsion under threat of dismissal* is to be the test of allowance of a deduction, as the court below held and the Government asserts here, then Petitioner readily admits that the expenditure would not qualify.[3] But compulsion has not been the test previously employed by the Tax Court,[4] and more important it is not the test of the landmark decision of the Court of Appeals for the Second Circuit in *Schmidlapp*.

The assertion that *Schmidlapp* supports the decision below ignores the vital difference between "encouragement" and "compulsion". Many companies, including the company

[1] P. 5.

[2] *Schmidlapp* v. *Commissioner*, 96 F. 2d 680 (2d Cir. 1938).

[3] The statement in Respondent's Brief at p. 8 that "Taxpayer sought to prove . . . that the Noland Company required him to incur the expenses. (App. 17.)" is not supported by the record.

[4] See Petition at pp. 7-8.

involved here, expect their officers to bear personally the cost of entertaining company customers and employees, particularly when these expenditures benefit both the officer and the company simultaneously. But after making its general policy known, most companies leave the matter to the employee's initiative and discretion. This was obviously true in *Schmidlapp*, as the normal practices of the banking world indicate and the court's citation of *Cohan* v. *Commissioner*, 39 F. 2d 540 (2nd Cir. 1930), emphasizes. Sometimes a company will give the employee further encouragement by considering his efforts in awarding an annual bonus. But other companies, including the bank in *Schmidlapp*, consider this only one of many duties for which his salary is adequate remuneration.

Since 1938, *Schmidlapp* has been regarded as the leading case on the deductibility by an employee of entertainment expenses incurred for the simultaneous benefit of his employer and himself. *Schmidlapp* established the test of *expectation*. However, in the present case the Court of Appeals below rejected that test and substituted the test of *compulsion*. The conflict is obvious.

Since many persons will be affected by the uncertainty in the application of the tax laws that will follow if the conflict remains unresolved, the petition for certiorari should be granted.

Respectfully submitted,

Dated: October 15, 1959

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